FILED
JUL 20 1955
HAROLD B. WILLEY, Clerk

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1955

No. 249

JOSEPH E. SHEARER and GEORGIA P. SHEARER,
Petitioners,

vs.

JAMES G. SMYTH, United States Collector of Internal Revenue,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals
for the Ninth Circuit.

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PRINAU-WALSH PRINTING CO., SAN FRANCISCO, CALIFORNIA

Subject Index

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statement of the case	3
Argument	7
I. The conflict of decisions	7
A. The decisions of the Second, Seventh and Eighth Circuit Courts of Appeals (and of the Tax Court of the United States)	7
B. The decisions of the Ninth Circuit Court of Appeals	13
II. The fact that petitioners were real estate brokers is of no significance	15
III. The status of the District Court's ultimate finding on appeal and review	16
Conclusion	17

Table of Authorities Cited

Cases

	Pages
Chicago Title and Trust Co. v. U.S., CCA-7, 209 Fed. 2d 773 (1954)	9, 15
Comm'r. v. Smith, CCA-2, 203 Fed. 2d 310	17
Daniel W. Ellis, T. C. Memo. (1954), Prentice-Hall T. C. Memo. Service, para. 54,021	11, 14, 15
Dillon v. Commissioner, 213 Fed. 2d 218	9, 14, 16, 17
Ehrman v. Commissioner of Internal Revenue, CCA-9, 120 Fed. 2d 607	10, 13
McGah v. Comm'r., CCA-9, 210 Fed. 2d 769	17
Palos Verdes Corp. v. U. S., CCA-9, 201 Fed. 2d 256	10, 13
Phipps v. Commissioner of Internal Revenue, CCA-2, 54 Fed. 2d 469	7, 8, 9, 10, 14, 15
Schwerin Trust, T. C. Memo. (1954), Prentice-Hall T. C. Memo. Service, para. 54,069	10, 14
Smith v. Dunn, CCA-5, No. 15368, June 30, 1955, reported at 1955 Prentice-Hall Federal Tax Service, para. 72,822	10, 17
Stern Brothers & Co. v. Comm'r., 16 T.C. 295	16
United States v. United States Gypsum Co., 333 U.S. 364	17
United States v. Robinson, 129 Fed. 2d 297	10
Washburn v. Comm'r., CCA-8, 51 Fed. 2d 949	17

Codes

Internal Revenue Code of 1939:	
Section 117	10, 16
Section 117(a)(1) as amended and as applicable to the year 1946 (26 U.S.C., 1946 Ed., Sec. 117)	2, 3
Section 117(j) as amended and as applicable to the year 1946 (26 U.S.C., 1946 Ed., Sec. 117)	2, 3
Section 3772	3
28 U.S.C. 1254(1)	2
28 U.S.C. 1340	3
28 U.S.C. 2101(c)	2

Miscellaneous

Treasury Regulations 111:
Section 29.117-1 3
Section 29.117-7 3
T. C. Memo., 1953, Prentice-Hall T. C. Memo. Service, para. 53,099 10

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PETITION FOR A WRIT OF CERTIORARI to the United States Court of Appeals for the Ninth Circuit.

OPINIONS BELOW.

The opinion of the Court of Appeals is reported at 221 Fed. 2d 478. The opinion of the District Court is reported at 116 F. Supp. 230.

JURISDICTION.

The judgment of the Court of Appeals here sought to be reviewed was dated and entered on April 22, 1955. Jurisdiction in this Court to review the said judgment by writ of certiorari is conferred by Title 28 USC 1254(1), this petition being filed within the time prescribed by Title 28 USC 2101(c).

QUESTION PRESENTED.

This case presents the question as to whether the gain derived on the sale of certain real estate acquired by Mr. and Mrs. Shearer in 1939 for use as a personal residence, for truck farming and for investment, and sold by them in 1946, should be taxed as ordinary income or as capital gain.

The question is: was this real estate held by Mr. and Mrs. Shearer "primarily for sale to customers in the ordinary course of . . . trade or business" within the meaning of that phrase as used in sections 117(a)(1) and 117(j) of the Internal Revenue Code of 1939, as amended (see Appendix).

The petitioners contend that the law applicable to the factual situation presented by this case is that the real estate was not held by them "primarily for sale to customers in the ordinary course of . . . trade or business", and therefore that the gain derived on sale should be taxed as capital gain rather than as ordinary income. The petitioners contend that the Court of Appeals for the Ninth Circuit, in deciding

to the contrary, has rendered a decision in conflict with the decisions of other courts of appeal on the same matter.

This case involves sections 117(a)(1) and 117(j) of the Internal Revenue Code of 1939, as amended and as applicable to the year 1946 (26 USC 1946 ed., Sec. 117); and sections 29.117-1 and 29.117-7 of Treasury Regulations 111, as amended and applicable to the year 1946. The pertinent text of the applicable statute and regulations is set forth in the Appendix.

STATEMENT OF THE CASE.

Petitioners brought this action in the United States District Court for the Northern District of California to recover Federal income taxes for the year 1946, together with interest thereon. As husband and wife, residents of California, each had filed a separate income tax return for 1946. On or before March 15, 1950 each filed a claim for refund. Notices of disallowance dated September 13, 1951, were sent to the petitioners by registered mail. Within the time provided for in section 3772 of the Internal Revenue Code of 1939, on September 18, 1951, the petitioners brought this action in the District Court. Jurisdiction in the District Court was conferred by 28 USC 1340.

In February 1939, Mr. and Mrs. Shearer acquired, in exchange for their personal residence located in

Palo Alto, California (R. 36),* 19.5 acres of land in the town of Atherton, California. Prior thereto, from 1919 to 1926, petitioner Joseph Shearer had truck farmed this land (R. 35-36). The Shearers purchased the said land in 1939 for three purposes: for use as a residence, for truck farming, and as a long-term investment.

An ordinance adopted by the Town of Atherton in 1939 precluded the Shearers from truck farming the land. From 1939 to and including 1944, the Shearers raised hay on the said land under a share-crop arrangement, using their share of the hay as feed for their cattle (R. 46).

The Shearers were prevented from building a personal residence on the said land by wartime restrictions on construction (R. 65). In 1943-1944, petitioner Georgia P. Shearer became seriously ill with pneumonia and was advised to live in the drier climate of Los Altos, California, rather than in Atherton. In 1944, the Shearers decided to liquidate their investment in the said Atherton land.

Commencing in the latter part of 1944, the petitioners attempted to sell the said Atherton land as a unit. The only offer received for the land was an offer to exchange for the land an office building worth less than the cost to the petitioners of the Atherton land. In 1945, petitioner Joseph Shearer was advised by a town councilman that if he wanted to liquidate

*Numbers in parentheses refer to pages of the printed record, petitioners having elected to file copies herewith under Rule 21(4).

his investment in the Atherton land, the best thing to do would be to subdivide it immediately, because the Town of Atherton was at that time drafting an ordinance to increase the minimum size of subdivision lots in that area from 28,500 square feet to one acre (R. 49). Not having been able to make a satisfactory sale of the land as a unit, the petitioners decided that the only prudent way to liquidate their investment in the Atherton land was by means of subdivision and sale (R. 48-49).

Petitioner Joseph Shearer in 1945 arranged for the subdivision and necessary improvements. The land was subdivided into 25 lots. The required improvements were made at a cost of $24,822. The lots were advertised for sale (R. 77, 80-82). Of the 25 lots, 24 were sold before the end of 1946. The net gain realized by the petitioners from the sale of these 24 lots was $34,254.72. Petitioner Georgia P. Shearer devoted no time or effort whatsoever to either the subdivision of the Atherton land or the sale of the lots into which it was divided (R. 83). Petitioner Joseph Shearer arranged for the subdivision and improvement of the property; and gave not more than five per cent of his time to the sale of the lots, devoting no more than a number of Sunday afternoons to such sales (R. 50-51).

With the proceeds derived from the liquidation of their investment in the said Atherton land by way of subdivision and sale, the petitioners purchased three income-producing real properties which they

still own and hold for investment, not for sale (R. 51-52).

The petitioners, or either of them, have never subdivided for sale any real estate other than the said Atherton land (R. 52). The subdivision and sale of the said Atherton land, which commenced in 1945 and was practically completed by the end of 1946, was the one isolated single instance in which the petitioners subdivided and sold real estate (R. 52). The petitioners, or either of them, have never at any time bought real estate with the intention of subdividing it for sale (R. 52).

The petitioners at all times here material have owned and held for investment and income, and for use in farming and cattle-raising, substantial amounts of real estate, including the Atherton land here in issue (R. 42-47). Except for the said Atherton land, the petitioners still own, and hold for investment and use, not for sale, all of the real estate which they owned at the end of 1945 (R. 43-45).

The petitioners, or either of them, have not at any time engaged in an ordinary course of trade or business as dealers in real estate (R. 37). In addition to devoting the major part of their time to farming and cattle-raising (R. 33-36, 43-45, 56-57), the petitioners during the years here material conducted, on a part-time basis, a real estate brokerage business in which they sold property for others, earning commission income for their services (R. 36-37). In this brokerage business, the petitioners did not purchase real estate for resale, except that, during the fourteen

year period 1939-1953, it was in three isolated instances necessary for the petitioners to purchase property on their own account in order to close sales and thereby obtain commission income (R. 37-43).

In the face of the facts as above set forth, the Court of Appeals for the Ninth Circuit affirmed the conclusion of the District Court that

> "Commencing in 1945 with the subdivision of Atherton Tract, plaintiffs held the property primarily for sale to customers in the ordinary course of their trade or business."

As will be shown in the next following section, this decision is in direct conflict with decisions of the Courts of Appeals for the Second, Seventh and Eighth Circuits.

ARGUMENT.

1. THE CONFLICT OF DECISIONS.

A. The Decisions of the Second, Seventh and Eighth Circuit Courts of Appeals (and of the Tax Court of the United States).

In *Phipps v. Commissioner of Internal Revenue* CCA-2, 54 Fed. 2d 469, the question presented was identical with the question here presented: whether or not real estate which had been disposed of by means of subdivision and sale was property "held by the taxpayer primarily for sale in the course of his trade or business" within the meaning of Federal income tax law. The facts in that case were as follows:

1. The taxpayers purchased a tract of unimproved "jungle" land at Palm Beach, Florida, in 1916.

2. Soon thereafter, the taxpayers had the tract cleared and graded, surveyed and platted into about 70 lots, ornamented with trees, and furnished with roads, water, sewers and electricity. Total cost was $143,255.45.

3. Sales of lots were made over several years, commencing in 1916, all of the lots being sold by October, 1929. In 1924 and 1925, the years in question, these sales yielded profits of $42,367.74 and $41,948.35, respectively.

4. *The evidence did not disclose that the taxpayers had in any other instance disposed of an investment in real estate by way of subdivision and sale. It would appear that only in this one instance did they liquidate an investment in real estate by subdivision, improvement and sale.*

The Board of Tax Appeals in the *Phipps* case, 19 BTA 1293, had sustained the Commissioner of Internal Revenue in denying capital gain treatment with respect to the profits realized on the sales of lots in 1924 and 1925. The Board concluded that the evidence clearly showed that the property was held by the taxpayers primarily for sale in the course of their business. The Second Circuit Court felt compelled to reverse the Board, and Judge Augustus Hand, speaking for the Court, reasoned as follows (54 F. 2d 469 at pp. 470-471):

"If it be argued that the sales of these lots when taken with the purchases and sales of other land we have mentioned were sufficient to amount to a business in real estate, the answer is that any real estate transactions which occurred in 1924 and 1925 were too limited to amount to a business in real estate. . . . While the purchases were made with the hope of profitable sales at some future time they do not seem to have been sufficiently engrossing, to give the taxpayers the vocation of real estate dealers or operators in 1924 or 1925. . . . There should be a greater continuity and larger absorption of time in such transactions to make the taxpayers more than investors. . . . *They had not continuously engaged in the development and sale, or the purchase and sale of lands. Mente v. Eisner,* 266 F. 161; *Cadwalader v. Lederer,* 274 F. 753; *Bedell v. Comm'r.,* 30 F. (2d) 622; *Rogers v. U. S.,* 41 F. (2d) 865; *Washburn v. Comm'r.,* 51 F. (2d) 949; *Heiner v. Tindle,* 276 U.S. 582." [Text italics supplied.]

The Court of Appeals for the Seventh Circuit cited and followed *Phipps v. Commissioner,* supra, in the recent case, *Chicago Title and Trust Co. v. U. S.,* CCA-7, 209 Fed. 2d 773 (1954), the opinion reading in part as follows:

". . . regular operation of a business requires such continuity and expenditure of time in the transactions as to indicate a permanent engagement in the business . . ."

The Court of Appeals for the Eighth Circuit in *Dillon v. Commissioner,* 213 Fed. 2d 218, decided that,

where the taxpayer decided in 1945 to liquidate an investment in 20 houses, and in 1946 advertised the houses for sale and sold the houses in 20 separate transactions. deriving net gain of $45,408.41 from such sales, this was not sufficient to constitute a trade or business under section 117 of the Internal Revenue Code of 1939. Tax Court decision to the contrary (T.C. Memo., 1953, Prentice-Hall T.C. Memo. Service, para. 53,099) reversed. (See Tax Court's Findings of Fact, which show that the taxpayer had been in the business of building and selling houses.)

The Court of Appeals for the Fifth Circuit, in *United States v. Robinson,* 129 Fed. 2d 297, 300, criticized the decisions of the Ninth Circuit on the point here at issue, and cited *Phipps v. Commissioner,* supra, in support of its criticism. See also the very recent decision of the Fifth Circuit in *Smith v. Dunn,* CCA-5, No. 15368, June 30, 1955, reported at 1955 Prentice-Hall Federal Tax Service, para. 72,822, which reversed the District Court and criticized the District Court's charge to the jury. The District Court's charge to the jury reflected the concept of the law as developed in the Ninth Circuit (see the *Ehrman* and *Palos Verdes* cases, infra), and the Fifth Circuit reversed.

The Tax Court of the United States cited and followed *Phipps v. Commissioner,* supra, in the recent case, *Schwerin Trust,* T. C. Memo. (1954), Prentice-Hall T. C. Memo. Service, para. 54,069. In *Schwerin Trust,* the facts show sales in one year of 16 lots yielding a net gain of $40,695.83, plus a sale in the

same year of an 80 acre tract yielding a net gain of $35,200.97.

In another recent Tax Court case, *Daniel W. Ellis,* T. C. Memo. (1954), Prentice-Hall T. C. Memo Service, para. 54,021, the facts were as follows: In 1935 the taxpayer inherited a tract of 166 acres located about three miles southwest of Charleston, South Carolina. Prior to 1946 the tract was used as agricultural land. In 1946, the taxpayer subdivided 44 acres of the tract into 72 lots suitable for home building. An engineering firm was hired to survey and establish lines for the subdivision. The work of putting the lots in condition for residential use consisted of putting in five streets, draining and cleaning ditches, installation of culverts, removal of trees and bushes, etc. The taxpayer employed an agent to supervise the subdivision and handle sales. Sale of the lots was advertised. In 1946, 56 lots were sold; in 1947, 8 lots; in 1948, 5 lots. All of the sales were made either by the taxpayer or his agent. The net gain from the sale of lots was $16,182.81 in 1946; $6,981.62 in 1947; and $2,312.24 in 1948. The tax years in litigation were 1946, 1947 and 1948.

The Tax Court, on the basis of the facts as above set forth, found and decided that the taxpayer should not be considered to have been engaged in the trade or business of selling real estate in the years in question. In deciding the *Ellis* case, the Tax Court said:

> "At the outset the inquiry may be narrowed to the question whether the sales made by the petitioner or on his behalf were in the *ordinary*

course of his business, since it is obvious from our findings of fact that between 1946 and 1948, the lots in petitioner's subdivision were held by him primarily for sale. In order to determine whether the petitioner was engaged in a business when he subdivided and sold a part of the real property he inherited, his conduct must be measured by the standards which have evolved from the numerous cases dealing with this question. The more important criteria in this determination are the reason for the taxpayer's acquiring the property in question; the sales activity of the taxpayer or those acting on his behalf, such as improving the property, soliciting sales by advertising or more direct approach to prospective buyers; the continuity of sales or sales-related activity over a period of time; and the number, frequency and substantiality of sales. *Considered in the light of these criteria we do not think that the activities of the petitioner were such that he should be considered as having been engaged in the trade of business of selling real estate in the years in question."* [Italics supplied.]

On the basis of the foregoing analysis of the cases in the Second, Seventh and Eighth Circuits, and in the Tax Court, it would seem apparent that, in the instant case, the decision in those Circuits and in the Tax Court would have been that the Shearers did not hold the Atherton land primarily for sale to customers in the ordinary course of their trade or business, despite the fact of subdivision and sale. Applying the rationale of the decisions above discussed to the facts of the instant case, the conclusion would have to be

that in the instant case there was not a sufficient quantum of sales and sales-related activity over a sufficient period of time to constitute the subdivision and sale an "ordinary course of trade or business".

B. The Decisions of the Ninth Circuit Court of Appeals.

In *Ehrman v. Commissioner of Internal Revenue*, CCA-9, 120 Fed. 2d 607, 610, the Court of Appeals for the Ninth Circuit said:

> "The sole question is—were the taxpayers in the business of subdividing real estate? If they were, then it seems indisputable that the property constituted 'property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business'."

In *Palos Verdes Corp. v. U. S.*, CCA-9, 201 Fed. 2d 256, the Court of Appeals for the Ninth Circuit laid down the proposition that if a real estate investment is liquidated by means of subdivision and sale, *the use of this method of disposal requires the conclusion that the property is held for sale "to customers in the ordinary course of trade or business of real estate."*

On the basis of these Ninth Circuit decisions, the defendant in the instant case (the respondent here) argued on brief that

> "The law is well settled in the Ninth Circuit that where property is subdivided and active steps are taken to sell the lots in such subdivision to separate purchasers, a taxpayer holds that property 'primarily for sale to customers in the ordinary course of his trade or business'."

Petitioners, on the basis of the Ninth Circuit's decision in the instant case, cannot help but agree that the respondent's analysis of the Ninth Circuit's position with respect to the point at issue is quite correct.

In the instant case, the quantum of activity, the substantiality of the sales, and the period of time required to complete the liquidation of the investment by way of subdivision and sale was far less than in the *Phipps* case, supra, and about the same as in the *Dillon, Schwerin Trust* and *Ellis* cases, supra.

It is to be noted that in the instant case the District Court in its opinion did not choose even to mention, much less attempt to distinguish the *Phipps* and *Ellis* cases, despite the fact that both cases are directly in point and were stressed in the reply brief filed by the plaintiffs (the petitioners here). Nor did the Court of Appeals for the Ninth Circuit mention or attempt to distinguish the several cases from the other Circuits and from the Tax Court hereinabove discussed, although all of these several cases were called to the attention of the Court of Appeals either on brief or in oral argument. The decision of the District Court, affirmed by the Court of Appeals, that

> "The disposition of the Atherton tract by plaintiffs was of such size and called for such substantial investment and devotion of time as to place it outside the scope of a capital transaction"

is obviously in direct conflict with the several cases from the other Circuits and from the Tax Court hereinabove discussed, particularly with the Second Cir-

cuit's decision in the *Phipps* case and the Tax Court's decision in the *Ellis* case, supra.

One final point with reference to the conflict of decisions remains to be made. The subdivision and sale in the instant case could not possibly be held to constitute "an ordinary course of trade or business" within the meaning of that phrase as used in section 117 of the Internal Revenue Code of 1939, under the language above-quoted from the decision of the Court of Appeals for the Seventh Circuit in *Chicago Title and Trust Co. v. U. S.*, supra. And yet, in the instant case, the Court of Appeals for the Ninth Circuit affirmed the ultimate finding and conclusion of the District Court that:

> "Commencing in 1945 with the subdivision of the Atherton tract, plaintiffs held the property primarily for sale to customers in the ordinary course of their trade or business."

II. FACT THAT PETITIONERS WERE REAL ESTATE BROKERS IS OF NO SIGNIFICANCE.

The fact that the petitioners devoted part of their time to a real estate brokerage business, in which they earned commission income for selling property owned by others, is of no significance as a factor in the case. Even had the petitioners been "dealers" (which the facts of record show they were not), such fact would be of no significance in view of the District Court's finding that the Atherton land was acquired and held by the petitioners, until its liquidation and sale, for personal use, for truck farming, and

as a long-term investment. *Dillon v. Commissioner,* CCA-8, supra. In the *Dillon* case, the facts as found by the Tax Court show that the taxpayer had been in the business of building and selling houses. See also, *Stern Brothers & Co. v. Comm'r.,* 16 T.C. 295, 313, acquiesced to by the Commissioner, Cum. Bulletin 1951-2, p. 4.

The focal point of the conflict between the Ninth Circuit on the one hand and the Second, Seventh and Eighth Circuits (and the Tax Court) on the other is the affirmance by the Ninth Circuit of the District Court's ultimate finding in the instant case that:

> "Commencing in 1945 with the subdivision of Atherton tract, plaintiffs held the property primarily for sale to customers in the ordinary course of their trade or business."

Petitioners request the Court to consider all of the facts of record and to draw its own ultimate conclusion therefrom.

III. THE STATUS OF THE DISTRICT COURT'S ULTIMATE FINDING ON APPEAL AND REVIEW.

The question as to whether a gain was or was not realized by the taxpayer "in the ordinary course of his trade or business", within the meaning of that phrase as used in section 117 of the Internal Revenue Code of 1939 is a mixed question of law and fact; and even though the trial Court designates its conclusion with respect to such question as an ultimate finding of fact, it nevertheless constitutes a conclusion of

law subject to review. On the issue here presented, this Court may consider the facts of record and draw its own ultimate conclusion therefrom.

U. S. v. United States Gypsum Co., 333 U.S. 364, 394-395;

Comm'r. v. Smith, CCA-2, 203 Fed. 2d 310, 311;

McGah v. Comm'r., CCA-9, 210 Fed. 2d 769;

Washburn v. Comm'r., CCA-8, 51 Fed. 2d 949, 951;

Dillon v. Commissioner, CCA-8, 213 Fed. 2d 218;

Smith v. Dunn, CCA-5, No. 15368, June 30, 1955.

CONCLUSION.

It is respectfully submitted that certiorari should be granted in the present case to settle the conflict between the decision of the Court of Appeals for the Ninth Circuit in this case and the decisions of the Courts of Appeals for the Second, Seventh, and Eighth Circuits; and it is further respectfully submitted that the decision of the Court of Appeals in this case should be reversed.

Dated, San Francisco, California,
July 18, 1955.

WILLARD C. MILLS,
Counsel for Petitioners.

(Appendix Follows.)

Appendix

United States Court of Appeals
for the Ninth Circuit

JOSEPH E. SHEARER and GEORGIA P. SHEARER, *Appellants,* vs. JAMES G. SMYTH, United States Collector of Internal Revenue, *Appellee.*	No. 14,228 Apr. 22, 1955

Appeal from the United States District Court for the Northern District of California, Southern Division.

Before Mathews and Orr, Circuit Judges, and Byrne, District Judge.

Per Curiam.

On the grounds and for the reasons stated in its opinion, Shearer v. Smyth, D.C.N.D.Cal., 116 F. Supp. 230, the judgment of the District Court is affirmed.

(Endorsed:) Per Curiam Opinion. Filed Apr. 22, 1955. Paul P. O'Brien, Clerk.

(Note): The opinion of the District Court is set forth in the printed record filed herewith, at pp. 16-22.

United States Court of Appeals
for the Ninth Circuit

JOSEPH E. SHEARER and GEORGIA P. SHEARER, *Appellants,* vs. JAMES G. SMYTH, United States Collector of Internal Revenue, *Appellee.*	No. 14,228

JUDGMENT

Appeal from the United States District Court for the Northern District of California, Southern Division.

This cause came on to be heard on the Transcript of the Record from the United States District Court for Northern District of California, Southern Division, and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the Judgment of the said District Court in this cause be, and hereby is affirmed.

(Endorsed) Judgment

Filed and Entered: April 22, 1955

Paul P. O'Brien, Clerk.

RELEVANT PROVISIONS OF SECTION 117 OF THE INTERNAL REVENUE CODE OF 1939, AS APPLICABLE TO THE TAXABLE YEAR 1946.

Sec. 117. CAPITAL GAINS AND LOSSES.

(a) Definitions—As used in this chapter—

(1) Capital assets.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include * * * property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business * * * or real property used in the trade or business of the taxpayer.

* * * * * * *

(j) Gains and Losses from * * * Sale or Exchange of Certain Property Used in the Trade or Business.—

(1) Definition of Property Used in the Trade or Business.—For the purposes of this subsection, the term "property used in the trade or business" * * * [includes] real property used in the trade or business, held for more than six months, which is not * * * property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(2) General rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business * * * exceed the recognized losses from such sales [and] exchanges, * * * such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months * * *

(26 U.S.C. 1946 ed., Sec. 117.)

RELEVANT PROVISIONS OF REGULATIONS 111 APPLICABLE TO THE TAXABLE YEAR 1946.

Sec. 29.117-1 (As amended by T.D. 5425, Dec. 29, 1944).

Meaning of terms.—

The term "capital assets" includes all classes of property not specifically excluded by section 117(a)(1). In determining whether property is a "capital asset," the period for which held is immaterial.

The exclusion from the term "capital assets" * * * of real property used in the trade or business of a taxpayer is limited to such property used by the taxpayer in the trade or business at the time of the sale, exchange, or involuntary conversion. Gains and losses from the sale or exchange of such property are not subject to the percentage provisions of section 117(b) and losses from such transactions are not subject to the limitations on losses provided in section 117(d), except that under section 117(j) the gains and losses from the sale or exchange of such property held for more than 6 months may be treated as gains and losses from the sale or exchange of capital assets, and may thus be subject to such limitations. See section 29.117-7. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term "capital assets" even though depreciation may have been allowed with respect to such property under section 23(l) prior to its amendment by the Revenue Act of 1942. However, gain or loss upon the sale or exchange of land held by a taxpayer primarily for sale to customers in the

ordinary course of his business, as in the case of a dealer in real estate, is not subject to the limitations of section 117(b), (c), and (d). The term "ordinary net income" as used in these regulations for the purposes of section 117 means net income exclusive of gains and losses from the sale or exchange of capital assets.

Section 29.117-7 (As amended by T.D. 5394, July 27, 1944).—Gains and losses from involuntary conversions and from the sale or exchange of certain property used in the trade or business.—

Section 117(j) provides that the recognized gains and losses

> (a) from the sale, exchange, or involuntary conversion of property used in the trade or business of the taxpayer at the time of the sale, exchange, or involuntary conversion, held for more than six months, which is
>
> * * * * * * *
>
> (2) real property,
>
> provided that such property is not * * * held by the taxpayer primarily for sale to customers in the ordinary course of trade or business, * * *

shall be treated as gains and losses from the sale or exchange of capital assets held for more than six months if the aggregate of such gains exceeds the aggregate of such losses. * * *

INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statute and regulations involved	2
Statement	2
Argument	4
Conclusion	7
Appendix	8

CITATIONS

Cases:

Chicago Title & Trust Co. v. *United States*, 209 F. 2d 773	6
Dillon v. *Commissioner*, 213 F. 2d 218	5, 6
Dougherty v. *Commissioner*, 216 F. 2d 110	5
Ellis v. *Commissioner*, decided January 13, 1954	6
Goldberg v. *Commissioner*, decided June 21, 1955	7
Home Co. v. *Commissioner*, 212 F. 2d 637	5
Phipps v. *Commissioner*, 54 F. 2d 469	6
Schwerin Trust v. *Commissioner*, decided March 11, 1954	6
Smith v. *Dunn*, decided June 30, 1955	5, 6, 7
Stockton Harbor Indus. Co. v. *Commissioner*, 216 F. 2d 638, certiorari denied, 349 U.S. 904	5
United States v. *Robinson*, 129 F. 2d 297	

Statute:

Internal Revenue Code of 1939:	
Sec. 22 (26 U.S.C. 1952 ed., Sec. 22)	8
Sec. 117 (26 U.S.C. 1952 ed., Sec. 117)	8
Internal Revenue Code of 1954, Sec. 1237	6

Miscellaneous:

Treasury Regulations 111, Sec. 29.117-1	10

In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 249

JOSEPH E. SHEARER AND GEORGIA P. SHEARER, PETITIONERS

v.

JAMES G. SMYTH, UNITED STATES COLLECTOR OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the District Court (R. 16-22) is reported at 116 F. Supp. 230. The *per curiam* opinion of the Court of Appeals (R. 103) is reported at 221 F. 2d 478.

JURISDICTION

The judgment of the Court of Appeals was entered on April 22, 1955. (Pet. App. ii.) The petition for a writ of certiorari was filed on July 20,

1955. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether, on the facts of this case, the two courts below were correct in finding that the property involved was held primarily for sale to customers in the ordinary course of the taxpayers' trade or business, with the consequence that the profits from the sale of such property were taxable as ordinary income and not entitled to capital gain treatment under Section 117 (j) of the Internal Revenue Code of 1939, as amended.

STATUTE AND REGULATIONS INVOLVED

Sections 22 and 117 of the Internal Revenue Code of 1939, and Section 29.117-1 of Treasury Regulations 111, are set out in the Appendix, *infra,* pp. 8-12.

STATEMENT

For many years, including the years 1945 and 1946, the taxpayers have been engaged in the real estate brokerage business in the San Francisco peninsula area. Taxpayer Joseph E. Shearer also devotes part of his time to farming. (R. 23.)

In February, 1939, the taxpayers purchased as community property 19.5 acres of unimproved land in the City of Atherton, California (hereinafter referred to as the Atherton Tract). They purchased this tract for three purposes: for use as a residence, for truck farming, and as a long-term investment. (R. 23.)

Taxpayers never built a residence for themselves on the property, and an ordinance adopted by the City of Atherton in 1939 precluded them from engaging in truck farming. Until 1944 they leased out the Atherton Tract for the growing of hay on a share-crop arrangement. The value of their share of the hay grown on the land during the lease was considerably less than the taxes assessed against the land. Thus, taxpayers lost money on the property during the period it was leased for the growing of hay. (R. 17, 24.)

In 1944, after taxpayer Georgia P. Shearer had become ill with pneumonia and was advised to live in the drier climate of Los Altos, taxpayers listed the Atherton Tract with two San Francisco brokers for sale as a unit. The only offer they received was for an exchange for an office building appraised at somewhat less than the price that had been paid for the property. (R. 17, 24.)

Approximately one year later, in 1945, the taxpayers learned that the City of Atherton planned to increase the minimum size of subdivision lots from 28,500 square feet to one acre per lot. They then decided to undertake a prompt subdivision of the Atherton Tract in order to maximize their profit from the sale of subdivided lots. (R. 17-18, 24.)

Taxpayers accordingly subdivided the Atherton Tract into 25 lots. Toward that end taxpayer Joseph Shearer, as manager of the community property, caused to be prepared the necessary sub-

division map; instructed the surveyor to lay out the subdivision on the basis of the minimum 28,500 square feet per lot; arranged for street paving, sewer installation, water lines and electricity; erected "For Sale" signs on the tract; obtained permits for smaller signs; printed sales maps for use by him and other brokers in the sale of the lots; and advertised in four newspapers for sales of the lots. He also spent considerable time in the actual selling of the lots, although some of the lots were sold by other real estate brokers. The total cost to the taxpayers of subdividing and selling the lots was in excess of $24,000. Of the 25 lots, 24 were sold before the end of 1946, and the profit to the taxpayers from the sale of these 24 lots was $34,254.72 after deducting from the total sales proceeds the apportioned cost of acquisition, subdivision and sales. (R. 24-25.)

On the basis of these facts, the District Court made its finding that, commencing in 1945 with the subdivision of the Atherton Tract, taxpayers held the property primarily for sale to customers in the ordinary course of their trade or business. Accordingly, the court concluded that the profits realized by the taxpayers from the sale of the lots were taxable as ordinary income and not as capital gains. (R. 25.) The Court of Appeals affirmed *per curiam*. (R. 103.)

ARGUMENT

The two courts below were correct in finding that the taxpayers held the lots in their subdivision pri-

marily for sale in the ordinary course of their business and that the profits on the sales should accordingly be taxed as ordinary income. The determination is essentially one of fact. Turning on the particular circumstances of this case, it presents no adequate ground for certiorari.

Whether property is held primarily for sale in the ordinary course of a business is, as the lower courts have uniformly recognized, a question of fact on which only clear error can justify reversal of the fact-finding tribunal. *Stockton Harbor Indus. Co.* v. *Commissioner,* 216 F. 2d 638 (C. A. 9), certiorari denied, 349 U. S. 904; *Smith* v. *Dunn* (C. A. 5), decided June 30, 1955 (1955 C. C. H., par. 9543); *Dougherty* v. *Commissioner,* 216 F. 2d 110 (C. A. 6); *Dillon* v. *Commissioner,* 213 F. 2d 218 (C. A. 8); *Home Co.* v. *Commissioner,* 212 F. 2d 637 (C. A. 10). The record demonstrates that there was no such error here. Without restating the facts, it may be noted that the District Court's determination was supported by the continuity and frequency of the sales involved; the sales of 24 pieces of property in a single year can hardly be characterized as isolated or casual transactions. Moreover, taxpayers' activities in subdividing the Atherton Tract, improving the lots, and conducting a sales campaign to dispose of them further buttress the finding that they had entered into the business of selling their real estate. (R. 24-25.) Regardless of the personal reasons which may have led taxpayers to engage in these activities, the

decisive point is that the lower courts could reasonably find, as they did, that the activities amounted to a business.

The lower courts' appraisal of the particular facts here affords no basis for establishing the conflict taxpayers assert with decisions of other Courts of Appeals and the Tax Court. *Phipps* v. *Commissioner,* 54 F. 2d 469 (C. A. 2); *Chicago Title & Trust Co.* v. *United States,* 209 F. 2d 773 (C. A. 7); *Dillon* v. *Commissioner,* 213 F. 2d 218 (C. A. 8); *United States* v. *Robinson,* 129 F. 2d 297 (C. A. 5); *Smith* v. *Dunn* (C. A. 5), decided June 30, 1955 (1955 C. C. H., par. 9543); *Schwerin Trust* v. *Commissioner,* decided March 11, 1954 (1954 P-H T. C. Memorandum Decisions, par. 54,069); and *Ellis* v. *Commissioner,* decided January 13, 1954 (1954 P-H T. C. Memorandum Decisions, par. 54,021). Each of these decisions was necessarily hinged upon the particular set of facts presented. While there have been occasional intimations of divergence in emphasis (see *United States* v. *Robinson, supra,* at 300), the variety of factual circumstances makes it impossible to perceive clear lines of irreconcilable difference in the legal standards applied.

It should be noted, moreover, that Section 1237 of the Internal Revenue Code of 1954 formulates new and detailed rules to assist in determining whether and to what extent profit from sales of lots in subdivisions is to be treated as ordinary income or capital gain. Applicable to sales after December 31, 1953, this provision sharply diminishes the

future importance of cases, like the one here, arising under the 1939 Code.

Accordingly, it has been determined that the Government will not seek certiorari in such recent Fifth Circuit cases as *Smith* v. *Dunn, supra* (invoked by taxpayers as inconsistent with the instant decision, Pet. 10), and *Goldberg* v. *Commissioner,* decided June 21, 1955 (1955 C. C. H., par. 9519), in which taxpayers prevailed in claiming capital gain treatment on the ground that the real property involved was not held primarily for sale in the ordinary course of a business. The considerations underlying this determination apply equally here and lead us to submit that further review in this case is not warranted.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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AUGUST, 1955.

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income * * * from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; * * * or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 22.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or busi-

ness, of a character which is subject to the allowance for depreciation provided in section 23 (l) * * *.

* * * * *

(j) [as added by Sec. 151(b) of the Revenue Act of 1942, c. 619, 56 Stat. 798, and amended by Sec. 127(b) of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Gains and Losses from Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k) (1) or (2) is applicable.

(2) *General rule.*—If, during the taxable

year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.117-1. *Meaning of Terms.*—The term "capital assets" includes all classes of property not specifically excluded by section 117(a)(1). In determining whether property is a "capital asset," the period for which held is immaterial.

The exclusion from the term "capital assets" of property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 23(l) and of real property used in the trade or business of a taxpayer is limited to such property used by the taxpayer in the trade or business at the time of the sale, exchange, or involuntary conversion. Gains and losses from the sale or exchange of such property are not subject to the percentage provisions of section 117(b) and losses from such transactions are not subject to the limitations on losses provided in section 117(d), except that under section 117(j) the gains and losses from the sale or exchange of such property held for more than six months may be treated as gains and losses from the sale or exchange of capital assets, and may thus be subject to such limitations. See section 29.117-7. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term "capital assets" even though depreciation may have been allowed with respect to such property under section 23(l) prior to its amendment by the Revenue Act of 1942. However, gain or loss upon the sale or exchange of land held by a taxpayer primarily for sale to customers in the ordinary course of his business, as in the case of a dealer in real estate, is not subject to the limitations of section 117(b), (c), and (d). The term

"ordinary net income" as used in these regulations for the purposes of section 117 means net income exclusive of gains and losses from the sale or exchange of capital assets.

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☆ U. S. GOVERNMENT PRINTING OFFICE: 1958 054043 180

FILED
SEP 1 1955
HAROLD B. WILLEY, Clerk

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ADDENDUM TO PETITION FOR A WRIT OF CERTIORARI
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Table of Authorities Cited

	Page
Ehrman v. Commissioner, CCA-9, 120 Fed. 2d 607.....	2
Palos Verdes Corp. v. U. S., CCA-9 (1952), 201 Fed. 2d 256	2

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Contrary to the statement made by the respondent at page 6 of his brief in opposition to the granting of the writ, there is an absolutely irreconcilable difference between the legal standard applied in the Ninth

Circuit to the factual situation of subdivision and sale here presented and the legal standard applied in the other Circuits to comparable subdivision and sale factual situations. In the Ninth Circuit, the legal standard, set forth in *Palos Verdes Corp. v. U. S.*, CCA-9 (1952), 201 Fed. 2d 256, 259 is as follows: "If a real estate investment is liquidated by means of subdivision and sale, *the use of this method requires the conclusion* that the property is held for sale 'to customers in the ordinary course of trade or business.'" (See also, *Ehrman v. Commissioner*, CCA-9, 120 Fed. 2d 607, 610.) The Ninth Circuit's legal standard, as set forth in *Palos Verdes Corp.*, was applied by the two Courts below in deciding this case. (Printed Record, pp. 20-21.) In fact, at the hearing before the Court of Appeals for the Ninth Circuit, counsel for the petitioners was asked by the Court how he could hope to argue that the decision in *Palos Verdes Corp.* was not dispositive of the instant case; and counsel's argument that the two cases were clearly distinguishable on the basis of their dissimilar factual situations was given extremely short shrift. On the other hand, in the Second, Fifth, Seventh and Eighth Circuits, and in the Tax Court, there is no such legal rule that the use of the subdivision and sale method of liquidating an investment in real estate requires the conclusion that the property was held for sale "to customers in the ordinary course of trade or business". (See the analysis of the decisions in these other circuits, and in the Tax Court, appearing at pp. 7-13 of the petition for certiorari.) The legal

standard or test applied in these other circuits, and in the Tax Court, for determining whether a liquidation of an investment in real estate by means of a subdivision and sale constitutes an ordinary course of trade or business, is this: do the facts show such a continuity and regularity of engagement in real estate purchase, development, and sale activity and such a substantial expenditure of time in the transactions as to warrant the conclusion that the taxpayer is engaged in an ordinary course of trade or business as a dealer in real estate? Applying this legal standard or test to the facts in the instant case (see the statement of the case set forth in the petition), the decisions in prior cases involving comparable factual situations clearly indicate that there was not here a sufficient quantum of activity over a sufficient period of time to warrant the conclusion that the subdivision and sale of the Atherton acreage constituted an "ordinary course of trade or business".

Respondent, in his brief in opposition to the granting of the writ, states that the Government would itself have petitioned for writs of certiorari to the Fifth Circuit in two recent cases *on the very point here at issue,* except for the fact that a new statutory provision, not applicable until the taxable year 1954, sets forth new rules intended to diminish the future importance of the present conflict of authority on the question here presented. This amounts to an admission by the respondent that, in his opinion, there does presently exist the irreconcilable conflict of authority requisite for the granting of the writ.

The respondent's point that the newly-enacted statutory rules will diminish the future importance of the admitted conflict of authority on the question here presented is not well taken, for the following reasons:

1. The instant case involves the taxable year 1946. Undoubtedly hundreds, if not thousands, of cases involving this same question for the taxable years 1946-1953, inclusive, either now await decision or will arise for decision over many years to come. If certiorari on the question here presented is not granted, the law as applied to such cases in the Ninth Circuit will continue to conflict with the law as applied to such cases elsewhere in the United States.

2. The newly enacted rules are radically new, and do not enact into statutory law either of the conflicting legal standards now being applied by the Courts to the solution of the question here presented. Except for the fact that the new rules do indicate Congressional disapproval of the legal standard now being applied in the Ninth Circuit, they can be of no direct assistance in resolving the present conflict of authority.

Dated, San Francisco, California,
August 29, 1955.

WILLARD C. MILLS,
Counsel for Petitioners.